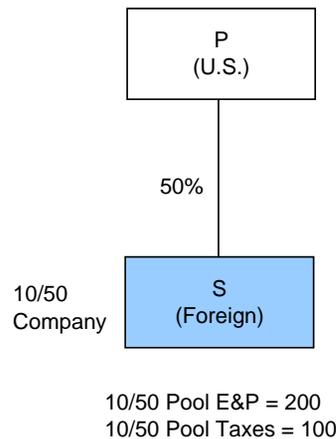


Temp. Reg. 1.904-7T(f)(iv), Example 2

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Commissioner is Unable to Reconstruct 10/50 Corporation's Historical Earnings & Taxes

January 1, 1987 to Dec. 31, 2002



The Commissioner is unable to determine the proper look-thru characterization. Thus, all of the earnings and taxes are assigned to the passive category.

Prior to the Taxpayer Relief Act of 1997 dividends from each 10/50 corporation were subject to a separate foreign tax credit limitation. The 1997 Act modified these rules, effective for taxable years beginning after December 31, 2002. The 1997 Act provided that 10/50 dividends out of pre-2003 earnings would be included in a single separate category and 10/50 dividends out of post-2002 earnings would receive look-thru treatment.

The American Jobs Creation Act of 2004 ("AJCA") modified the 10/50 dividend rules and provided that dividends from 10/50 corporations would be eligible for look-thru treatment effective for taxable years beginning after December 31, 2002, without regard to when the distributed earnings were accumulated.

If the look-thru treatment of a dividend out of earnings formerly accumulated in the non-look-thru pool has not been adequately substantiated, the dividend is treated as passive. To substantiate the look-thru characterization of the earnings and taxes in the non-look-thru pools, the taxpayer must reconstruct the non-look-thru pools of earnings and taxes for each year in the non-look-thru period.

Due to potential difficulties in reconstructing historical accumulated earnings and taxes accounts of a 10/50 corporation on a look-thru basis, a safe harbor allows a taxpayer to allocate the earnings and taxes in the non-look-thru pools ratably to the look-thru pools on the first day of the 10/50 corporation's first post-2002 taxable year in the same percentages as the taxpayer (or the qualified group member that owns the 10/50 corporation) properly characterizes the stock of the 10/50 corporation in the separate categories for purposes of apportioning the taxpayer's interest expense in its first taxable year ending after the first day of the 10/50 corporation's first post-2002 taxable year.

P, a domestic corporation, has owned 50% of the voting stock of S, a foreign corporation, at all times since January 1, 1987, and S has been a noncontrolled section 902 corporation (also known as a "10/50 corporation") with respect to P since that date. 1987 was the first year in which post-1986 undistributed earnings were accumulated in the non-look-thru pool of S. As of December 31, 2002, S had 200u of post-1986 undistributed earnings and \$100 of post-1986 foreign income taxes in its non-look-thru pools. P does not elect the safe harbor method to allocate the earnings and taxes in the non-look-thru pools and does not attempt to substantiate the look-thru characterization of S's non-look-thru pools. The Commissioner cannot reasonably determine the proper look-thru characterization of the 200u of undistributed earnings and \$100 of taxes in S's non-look-thru pools. Accordingly, the Commissioner will assign such earnings and taxes to the passive category, so that as of January 1, 2003, S has 200u of post-1986 undistributed earnings and \$100 of post-1986 foreign income taxes in the passive category, and the Commissioner will treat S as a passive category asset for purposes of apportioning P's interest expense.

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